

An Assessment of Capital Structure on Banking Performance (Evidence from Millie and Pashtany banks)

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Abstract: *This study investigates the impact of capital structure on the performance of state-owned commercial banks in Afghanistan, focusing on Bank-e-Milli and Pashtany Bank. Utilizing a quantitative research approach, the analysis is based on secondary data from 2010 to 2024, employing panel regression techniques including unit root, cointegration, and Hausman tests. Key performance indicators such as Return on Assets (ROA), Return on Equity (ROE), and Current Ratio were analyzed against capital structure variables like long-term debt, short-term debt, and asset growth. The findings reveal that long-term debt has a positive and statistically significant effect on ROA, while short-term debt has an insignificant or negative influence on performance metrics. Asset growth showed a positive but statistically insignificant impact. The results support the Pecking Order Theory and highlight the importance of strategic financing decisions in Afghanistan's banking sector. The study concludes that a cautious and well-balanced capital structure, especially emphasizing long-term financing, can enhance bank performance in emerging economies.*

Keywords: *Capital Structure, Return on Assets (ROA), Return on Equity (ROE), Asset Growth, Bank Performance*

1. Introduction

The capital structure of banks plays a pivotal role in determining their financial performance and stability. It refers to the way in which a bank finances its operations using a mix of debt and equity. A well-balanced capital structure is critical for ensuring profitability, reducing risk, and sustaining growth, especially in developing economies. In general, capital structure decisions can significantly impact a bank's financial health. On the one hand, banks with higher leverage, that is, more debt in their capital structure, can potentially achieve higher profitability, as they may benefit from the tax deductibility of interest payments. On the other hand, excessive debt may introduce significant risks, particularly in volatile or underdeveloped markets. Previous studies have highlighted the importance of an appropriate mix of debt and equity in improving bank performance while managing financial risk.

Bank performance refers to the effectiveness with which a bank utilizes its resources to achieve its financial and operational objectives. It is an important measure of a bank's financial health, stability, and ability to contribute to economic development. Bank performance is commonly assessed using financial indicators such as Return on Assets (ROA), Return on Equity (ROE), and the Current Ratio. Bank performance is influenced by both internal and external factors. Internally, a bank's capital structure, management efficiency, and risk management strategies

can play significant roles. Externally, macroeconomic conditions, regulatory frameworks, and market competition can also affect performance outcomes.

Capital structure in the banking business refers to the specific mix of equity and debt used by banks to finance their overall operations and activities. Unlike non-financial institutions, banks typically operate with relatively high financial leverage, relying heavily on customer deposits and other forms of debt as major sources of funding. Understanding the capital structure of banks is therefore important for assessing their financial performance, solvency, and exposure to financial risk. The choice between different sources and maturities of financing may influence the ability of banks to manage their resources and generate sustainable returns.

The capital structure of banks in Afghanistan reflects the characteristics of an emerging financial system influenced by economic and institutional challenges, underdeveloped capital markets, and reliance on traditional sources of funding. Afghan banks primarily rely on customer deposits and equity contributions from shareholders or the government, with relatively limited access to sophisticated financial instruments. These characteristics create particular challenges for financial institutions in managing liquidity, financial risk, and profitability. Therefore, examining the relationship between capital structure and bank performance in Afghanistan is important for understanding how financing decisions affect the financial outcomes of banks operating in this environment.

Despite the growing body of literature examining the relationship between capital structure and bank performance, previous studies have predominantly focused on banking sectors in countries such as Ghana, Nigeria, Ethiopia, India, Bangladesh, Tanzania, Pakistan, and Jordan. However, empirical evidence on the relationship between capital structure and bank performance in Afghanistan remains limited, particularly for state-owned commercial banks. Existing studies have therefore provided insufficient evidence on how different sources of financing, particularly long-term and short-term debt, affect the financial performance of state-owned banks operating under the economic and institutional conditions of Afghanistan. This gap is particularly relevant to Bank-e-Milli Afghanistan and Pashtany Bank, which are important state-owned commercial banks in the country. Therefore, this study aims to address this gap by examining the impact of capital structure on the performance of Bank-e-Milli Afghanistan and Pashtany Bank over the period 2010–2024. Specifically, the study examines the effects of long-term debt, short-term debt, and asset growth on key measures of bank performance, including Return on Assets (ROA), Return on Equity (ROE), and the Current Ratio.

2. Literature Review

This chapter explores the theoretical and empirical foundations underpinning the relationship between capital structure and banking performance. It begins with an overview of the relevant financial theory particularly the Pecking Order Theory which provides the conceptual lens for this study. Following the theoretical framework, a review of selected empirical studies from various developing countries is presented to highlight how capital structure decisions influence bank performance in different economic contexts.

2.1 Theoretical Framework

The theoretical framework of this study is built upon key financial theories that explain the relationship between capital structure and banking performance. There are few theories but the fairest theory is the pecking order theory.

Pecking Order Theory

This theory (Myers & Majluf, 1984) suggests that firms prioritize internal financing (retained earnings), followed by debt, and then equity issuance due to information asymmetry. In the banking context, this study investigates whether Millie and Pashtany Banks follow a similar pecking order when structuring their capital.

In the context of Afghanistan's underdeveloped financial markets and high levels of information asymmetry, the Pecking Order Theory provides a useful lens to examine how Bank-e-Millie and Pashtany Bank structure their capital. This study assesses whether these banks follow the theoretical hierarchy—preferring internal financing over debt and equity—and evaluates how such preferences influence their overall performance.

2.2 Empirical Literature review

Numerous studies have been conducted globally to examine the relationship between capital structure and bank performance, offering diverse insights across different economic and institutional contexts. However, for the purpose of this study, only ten key pieces of literature were selected based on their direct relevance to the banking sector, particularly in developing countries with economic characteristics similar to Afghanistan.

***Arhinful et al. (2023)** analyzed 15 Ghanaian financial institutions and found that capitalization ratios negatively impact net interest margin, loan-to-asset ratio, and ROA, while debt-to-EBITDA positively affects the loan-to-asset ratio but negatively impacts ROA and net interest margin. Listed institutions showed a significant impact on net interest margin, unlike non-listed ones. Their findings align with Modigliani and Miller's Proposition I, emphasizing that optimal debt-to-equity financing enhances firm value. This study adds to the debate on capital structure, reinforcing the need for strategic financial decisions to improve banking performance.*

***Mehzabin and Shahriar (2022)** analyzed 492 banks across 28 Asian countries (2004–2018) to examine how capital structure, operational efficiency, and non-interest income affect profitability. Their findings indicate that a higher leverage ratio significantly boosts bank profitability, supporting **agency cost theory** but contradicting **pecking order theory**. Additionally, lower operational costs and efficient cost management enhance profitability, while non-interest income plays a crucial role, especially in low-interest-rate environments. Their study highlights the importance of strategic debt financing and operational efficiency in improving banking performance across Asia.*

***Wangombe and Kibati (2019)** examined the impact of capital structure on the financial performance of licensed microfinance banks (MFBs) in Kenya. Their study found that **equity financing** had the strongest positive impact on profitability, followed by **retained earnings**, while **debt financing** had the least desirable effect. MFBs used trade credits, asset-based borrowing, and commercial finance companies for debt financing, but debt was advised to be used cautiously due to its potential risks. The study also highlighted that retained earnings contribute to financial stability and are commonly used for expansion. Their findings suggest that MFBs should prioritize equity financing and profit retention over excessive reliance on debt to maintain profitability and sustainable growth.*

Doku (2019) examined the relationship between capital structure and profitability in Ghanaian commercial banks. Analyzing data from 21 banks between 2000 and 2014, the study found that the capital-to-asset ratio is a significant and positive determinant of bank profitability, measured through return on assets (ROA) and net interest margin (NIM). The study also revealed that banks relying on cheap customer demand deposits tend to have higher profitability, as they can transfer overhead costs to customers through higher intermediation margins.

Musah (2018) investigated the impact of capital structure on the profitability of commercial banks in Ghana, analyzing 23 banks over a six-year period (2010–2015). The study found that Ghanaian banks are highly leveraged, with debt financing making up 84% of total capital, of which 77% consists of short-term debt. Regression results indicated that short-term and long-term debt ratios have a negative relationship with profitability, while the total debt ratio is positively related to profitability. The findings support the pecking order theory, suggesting that more profitable firms prefer internally generated funds over external debt. Additionally, the study found that firm size, foreign ownership, and bank age positively influence profitability, whereas growth in customer deposits negatively impacts profitability. These results highlight the importance of optimizing the mix of short-term and long-term debt to maximize bank profitability.

Siddik (2017) examined the impact of capital structure on the performance of banks in Bangladesh, analyzing 22 banks over a ten-year period (2005–2014). Using pooled ordinary least squares (OLS) regression, the study assessed bank performance through return on equity (ROE), return on assets (ROA). The findings revealed that capital structure has a negative impact on bank performance, suggesting that excessive reliance on debt reduces profitability. This study is particularly relevant to developing economies like Bangladesh, emphasizing the need for bank management and policymakers to formulate strategies that minimize dependence on debt to achieve an optimal capital structure. The findings align with previous studies that argue for a cautious approach to debt financing in the banking sector.

Zafar (2016) investigated the impact of capital structure on the performance of Pakistani banks using a sample of 25 banks listed on KSE or scheduled under SBP. The study applied multiple regression models to analyze the relationship between capital structure determinants (TDTA, TDTQ, SDTA, LDTA) and bank performance (ROA, ROE, EPS). The findings indicate a negative relationship between total debt to total equity and profitability metrics (ROA, ROE, EPS), but an overall positive association between capital structure and banking performance. The study suggests that capital structure decisions significantly influence the profitability of Pakistani banks.

Idode et al. (2014) examined the impact of capital structure on the profitability of Nigerian banks listed on the Nigerian Stock Exchange from 2008 to 2012. Using an ex post facto research design and multiple regression analysis, they assessed profitability through Return on Assets (ROA) and measured capital structure via debt-to-assets (LEVI) and equity-to-assets (LEVII) ratios. The study found a significant positive relationship between capital structure and profitability, suggesting that a balanced mix of debt and equity financing enhances bank performance.

Twairesh (2014) investigated the impact of capital structure on the financial performance of 74 non-financial firms in Saudi Arabia from 2004 to 2012. Using a fixed effects regression model, the study analyzed the effects of short-term debt, long-term debt, and total debt on firm performance, measured by Return on Assets (ROA) and Return on Equity (ROE). Results showed that all debt components significantly affected ROA, while only long-term debt influenced ROE. Additionally, firm size had a positive impact on ROA but not on ROE, highlighting the nuanced role of debt maturity and firm size in shaping performance.

Mujahid et al. (2014) examined the relationship between capital structure and financial performance in Pakistani banks using multiple regression analysis. Bank performance was measured through ROA, ROE, and EPS, while capital structure was assessed via long-term, short-term, and total debt to capital ratios. The study found a positive relationship between all forms of debt and performance, suggesting that a well-balanced mix of debt enhances profitability and shareholder value. The findings highlight the strategic importance of managing debt structure to improve financial outcomes in the banking sector.

3. Research Methodology

The research methodology for this study adopts a quantitative approach to assess the impact of capital structure on banking performance in Afghanistan, supported by empirical evidence specifically focusing on Bank-e-Milli and Pashtany Banks.

The population includes commercial banks operating in Afghanistan. However, the study is limited to two state-owned banks: Pashtany Bank and Bank-e-Milli Afghanistan. These banks are selected based on their historical significance, accessibility of data, and relevance to the public banking sector.

The study will use secondary data collected from publicly available financial reports of Bank-e-Milli and Pashtany, such as annual reports, balance sheets, and income statements. The data will cover 15 years period (2010-2024), for both banks 30 years, providing sufficient data points to analyze trends and draw meaningful conclusions.

The study focuses on the following variables to assess the impact of capital structure on bank performance:

Dependent Variables (Bank Performance Indicators):

Return on Assets (ROA): Measures the profitability of the bank relative to its total assets.

$$\text{Return On Assets} = \frac{\text{Net Income}}{\text{Total Assets}} \dots \text{Equation 1}$$

Return on Equity (ROE): Measures the profitability of the bank relative to shareholders' equity.

$$\text{Return On Equity} = \frac{\text{Net Income}}{\text{Total Equity}} \dots \text{Equation 2}$$

Current ratio: It measures a company's ability to meet its short-term obligations with its short-term assets. It is calculated as

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} \dots \text{Equation 3}$$

Independent Variable (Capital Structure):

Long-Term Debt to Capital: is a financial ratio that measures the proportion of a company's long-term debt in its overall capital structure.

$$\text{Long Term Debt} = \frac{\text{Long Term Debt}}{\text{Total Capital}} \dots \text{Equation 4}$$

Short-Term Debt to Capital: It measures the proportion of a company's short-term debt relative to its total capital.

$$\text{Short Term Debt} = \frac{\text{Short Term Debt}}{\text{Total Capital}} \dots \text{Equation 5}$$

Assets growth: refers to the increase in a company's total assets over a specific period, often reflecting its ability to expand operations, acquire new assets, or improve financial performance. It is an important indicator of growth and financial health.

$$\text{Assets Growth} = \frac{\text{Assets of Current Year} - \text{Assets of Previous Year}}{\text{Assets of Current Year}} \dots \text{Equation 6}$$

Empirical Findings

Multiple regression models are used to find out the association between capital structure characteristics and Bank performance in the context of Afghanistan. Three regression models are formulated to check the relationship between capital structure and banking performance. Our base models take the following form:

$$Y_{it} = \alpha + \beta_1 x_{1it} + \beta_2 x_{2it} + \beta_3 x_{3it} + \epsilon_{it}$$

Where:

Y_{it}	<i>Is the dependent variable</i>
β_0	<i>Is the intercept</i>
$X_{1it}, X_{2it} \text{ and } X_{3it}$	<i>are the independent variables</i>
ϵ_{it}	<i>Is the error term</i>
i	<i>Is the number of banks</i>
t	<i>Is the number of time periods</i>

Return on Assets (ROA):

$$ROA = \beta_0 + \beta_1 (LTD/C) + \beta_2 (STD/C) + \beta_4 (\text{assets growth}) + \epsilon$$

Return on Equity (ROE):

$$ROE = \beta_0 + \beta_1(LTD/C) + \beta_2(STD/C) + \beta_4(\text{assets growth}) + \epsilon$$

Current Ratio:

$$\text{Current Ratio} = \beta_0 + \beta_1(LTD/C) + \beta_2(STD/C) + \beta_4(\text{assets growth}) + \epsilon$$

Panel Unit Root Test Results				
Variables	Levin Lin Chu (p-value)	Stationarity	Fisher ADF (p-value)	Stationarity
Long term debt to capital	0.0468	Level	0.0000	1 ST Differance
Short term debt to capital	0.0456	1 st Differance	0.0300	1 ST Differance
Assets growth	0.0095	Level	0.0025	Level
ROA	0.0000	1 st Differance	0.0183	Level
ROE	0.0360	Level	0.0016	Level
Current Ratio	0.0173	1 st difference	0.0284	1 ST Differance

Figure 1. Panel Unite Root Test

Panel unit root tests using Levin-Lin-Chu and Fisher ADF show that some variables are stationary at level, while others became stationary after first differencing. This confirms that all variables are stationary and suitable for further panel data analysis.

Kao Cointegration Test		
Variables	P value	Result
ROA	0.0019	Cointegrated
ROE	0.0000	Cointegrated
Current Ratio	0.0066	Cointegrated

Figure 2. Cointegration Test

The Kao cointegration test results indicate that ROA, ROE and current ratio are cointegrated with their explanatory variables ($p < 0.05$).

<i>Hausman Test</i>				
<i>Variables</i>	<i>Chi-Square (χ^2)</i>	<i>Degrees of Freedom (df)</i>	<i>p-value</i>	<i>Model Preference</i>
ROA	0.03	3	0.9983	Random Effects
ROE	0.48	3	0.9227	Random Effects
Current Ratio	0.03	3	0.9987	Random Effects

Figure 3. Hausman Test

The Hausman test results show that for all three models (ROA, ROE, and Current Ratio), the p-values are above 0.05. This indicates no systematic difference in coefficients between fixed and random effects, justifying the use of random effects models for the analysis.

<i>Random effects regression results for ROA</i>				
<i>variable</i>	<i>coefficient β</i>	<i>std. error</i>	<i>z-value</i>	<i>p-value</i>
Long term debt to capital	0.1104	0.0552	2	0.045
Short term debt to capital	-0.0043	0.0039	-1.09	0.274
Assets growth	0.0003	0.0005	0.61	0.542
Constant	0.0007	0.0099	0.07	0.944

Figure 4. Random effect regression for ROA

Positive and statistically significant ($p = 0.045$).

Negative coefficient (-0.0043), but not statistically significant ($p = 0.274$).

Positive but very small and not statistically significant ($p = 0.542$).

<i>Random effects regression results for ROE</i>				
<i>variable</i>	<i>coefficient β</i>	<i>std. error</i>	<i>z-value</i>	<i>p-value</i>
Long term debt to capital	0.2526	0.5277	0.48	0.632
Short term debt to capital	0.0175	0.0372	0.47	0.637
Assets growth	0.0017	0.0043	0.39	0.699
Constant	-0.0229	0.0945	-0.24	0.808

Figure 5. Random effect regression for ROE

The positive coefficient (0.2526) suggests an increase in long-term debt is associated with an increase in ROE, but this effect is not statistically significant ($p = 0.632$).

Small positive effect (0.0175), but again not significant ($p = 0.637$).

Coefficient is very small and positive (0.0017), also not significant ($p = 0.699$).

<i>Random effects regression results for Current ratio</i>				
<i>variable</i>	<i>coefficient β</i>	<i>std. error</i>	<i>z-value</i>	<i>p-value</i>
<i>Long term debt to capital</i>	0.0518	0.1602	0.32	0.747
<i>Short term debt to capital</i>	-0.0063	0.0113	-0.56	0.579
<i>Assets growth</i>	0.0004	0.0013	0.3	0.763
<i>Constant</i>	-0.0268	0.0287	-0.93	0.351

Figure 6. Random effect regression for Current ratio

The coefficient is positive (0.0518) but not statistically significant ($p = 0.747$).

The coefficient is slightly negative (-0.0063) but not significant ($p = 0.579$).

Very small positive coefficient (0.0004) with no statistical significance ($p = 0.763$).

Results and Discussion

The study aimed to evaluate the effect of capital structure on the financial performance of two major state-owned banks in Afghanistan: Bank-e-Milli and Pashtany Bank. The findings of the random effects regression models reveal several important insights.

Firstly, long-term debt to capital has a positive and statistically significant impact on Return on Assets (ROA), indicating that when these banks utilize long-term debt effectively, they may enhance profitability. This supports the theory that long-term debt, when managed appropriately, can help banks expand operations and leverage tax advantages, contributing to better asset utilization.

However, the effects of long-term debt on Return on Equity (ROE) and the current ratio were found to be positive but not statistically significant. This implies that while long-term debt may influence equity returns and liquidity, the relationship is not strong enough to draw definitive conclusions in this context.

Conversely, short-term debt to capital showed a negative but insignificant impact on ROA and the current ratio, and a small positive but insignificant impact on ROE. This suggests that short-term borrowing does not substantially improve bank performance and may even introduce risk, consistent with concerns about liquidity stress and repayment pressures associated with short-term financing.

Regarding asset growth, all three models showed positive but statistically insignificant coefficients. Although asset growth indicates expansion and investment capacity, it alone does not appear to be a strong predictor of performance in the short term. This could be due to the time lag between asset acquisition and its contribution to financial outcomes, or possibly inefficiencies in asset utilization.

The cointegration tests confirm that ROA, ROE and current ratio are significantly associated with the capital structure variables in the long term, highlighting a meaningful relationship over time.

Overall, these findings imply that while elements of capital structure—particularly long-term debt—can positively influence banking performance, the relationship is nuanced and context-dependent. This aligns with theories such as the Pecking Order Theory, which suggests a preference for internal financing and cautious use of debt.

Conclusion

This study concludes that capital structure has a mixed impact on the performance of state-owned commercial banks in Afghanistan. Specifically:

- *Long-term debt is positively associated with ROA, supporting its role in enhancing profitability when used judiciously.*
- *Short-term debt appears to be less effective or even detrimental to performance, possibly due to increased financial risk.*
- *Asset growth, while a sign of expansion, does not show a strong immediate effect on performance indicators in the Afghan banking context.*

The overall results suggest that banks need to be strategic in their capital structure decisions. In particular, the judicious use of long-term debt can be beneficial, whereas over-reliance on short-term borrowing may not yield favorable performance outcomes. These findings reinforce the relevance of financial management strategies tailored to the economic and institutional realities of Afghanistan's banking sector.

Theoretical and Contextual Contribution

This study contributes to the existing literature on capital structure and bank performance by providing empirical evidence from an under-researched emerging banking market, Afghanistan. From a theoretical perspective, the findings provide support for the Pecking Order Theory, as the results indicate that the type and maturity of financing are important in determining bank performance. The positive and statistically significant effect of long-term debt on ROA suggests that appropriately structured long-term financing can contribute to more effective asset utilization and profitability, whereas the insignificant or negative effect of short-term debt indicates that reliance on short-term financing may not generate similar benefits. From a contextual perspective, the study extends existing research by focusing specifically on state-owned commercial banks in Afghanistan, with particular reference to Bank-e-Milli and Pashtany Bank. This is important because Afghanistan's banking sector operates under distinctive economic and institutional conditions that differ from those of many other developing economies. The findings therefore provide context-specific evidence for policymakers and bank managers regarding the importance of carefully managing financing decisions. Overall, the study enhances the understanding of how capital structure influences bank performance in an emerging and institutionally constrained environment and provides a basis for further research on financing strategies in Afghanistan's banking sector.

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